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# Net Profit Participations in the Motion Picture Industry

Hillary Bibicoff

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# COMMENT

## NET PROFIT PARTICIPATIONS IN THE MOTION PICTURE INDUSTRY

### I. INTRODUCTION

Why is it that some actors and investors in motion pictures who negotiate to receive a percentage of a film's profits receive nothing, even though the motion pictures they were involved in were very successful?<sup>1</sup> In addition to a salary, actors often contract to receive a percentage of "net profits" from a movie in which they are involved. Investors also agree to receive a percentage of net profits from the movie as a way of receiving a return on their investments. Often these groups receive little or no remuneration from these agreements.

Certainly, receiving a percentage of profits from a commercially successful feature film like United Artist's *Rain Man* (1988) is every investor's dream. However, the profit participants from *Rain Man* have so far received no return from their participation agreements, and are hoping that the proceeds from sales of videotapes of the movie will finally result in a profit for themselves.<sup>2</sup> Furthermore, in the much-publicized case of Paramount's *Coming to America* (1988), while worldwide box-office receipts as of March, 1990, were around \$250 million, as far as the net profit participants are concerned, the movie was still showing a \$17 million loss.<sup>3</sup> The "*Rain Man*" and "*Coming to America*" cases are not unusual. To the contrary, this situation is a common one. As stated in a PR Newswire, "[t]hough hundreds of motion picture profit participation deals are made annually by stars with the major studios, fewer than 10 percent result in a check to participants."<sup>4</sup>

How can a profitable movie like *Rain Man*, which, as of May, 1989, had generated a box office gross<sup>5</sup> of over \$300 million, result in zero prof-

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1. For example, *Ruthless People* (Touchstone Pictures, 1986) was still showing an 11 million dollar deficit as of July, 1987, although it had grossed 90 million dollars worldwide. L.A. Times, July 26, 1987, Calendar, at 23. *Who Framed Roger Rabbit?* (Touchstone Pictures, 1988), while grossing \$150 million dollars by January, 1989, was still showing a loss. L.A. Times, Jan. 15, 1989, Calendar, at 31, col. 1.

2. L.A. Times, Sep. 17, 1989, Calendar, at 32, col. 2.

3. L.A. Times, Mar. 23, 1990, Calendar, § F, at 1, col. 4.

4. PR Newswire, July 18, 1983.

5. "Box office gross" is the total amount of money the public spent on ticket sales at the theatres.

its for its investors, show an actual \$25.1 million dollar loss? The answer lies in the way studio profit participation contracts define "net profits."<sup>6</sup> The unwary profit participant may not realize just how much is taken out of the earnings "pot" before his or her share is calculated.

This article explains how these contracts work. It runs a hypothetical movie deal through profit participation contracts from two major studios: Twentieth Century Fox, Inc. ("Fox")<sup>7</sup> and Warner Brothers, Inc.<sup>8</sup> The purpose is to show exactly what is deducted from the pot before a profit participant's share is calculated. If contract language is ambiguous, the various possible results of the different interpretations are demonstrated.

The same is done with the profit participation contract unsuccessfully proposed by the Screen Actors Guild ("SAG") in its 1980 negotiations with the Alliance of Motion Picture and Television Producers for mandatory use where a SAG member received a profit participation, and by the Writers Guild of America ("WGA") in its 1981 negotiations.<sup>9</sup> This latter contract is much more favorable to the profit participant than the other two. The comparison of the SAG proposed contract with the two studio contracts illustrates how negotiating some small changes in the studio contracts would result in large differences in the amount of revenue that profit participants could realize.

The purpose of this article is to create a guide which can be used by profit participants to clarify what an investment in a movie will net them. This allows profit participants to either negotiate for changes in the contract terms, or at least enter into the contract knowing what they are getting. Thus, what has occurred to the participants in many movies will not happen to these newly educated participants. They will avoid an unpleasant surprise down the road, when dreams of gold do not come true.

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6. *Forbes*, Feb. 19, 1990, at 38. "According to industry insiders, the studios have, over the years, devised a definition of net profits that guarantees that profit participants will rarely receive anything substantial no matter how successful the film." *Id.*

7. The particular Fox contract I am using came from Entertainment Industries Contracts (Farber Ed.), Vol. 4, Ch. 28, Form 28-1 (hereinafter referred to as "Entertainment Industry Contracts"). Each studio actually uses many different profit participation contracts, but I selected this one due to its accessibility to all readers, regardless of affiliation with Fox.

8. Entertainment Industry Contracts, Form 28-2. Again, I selected this Warner Brothers contract due to its accessibility.

9. *Participations in the Motion Picture, Television, and Music Industries, Legal Aspects of the Entertainment Industry* Vic Netterville Memorial Lectures, Twenty-Seventh Annual Program, 355-74 (1981) (hereinafter referred to as "Participations in the Entertainment Industry"). Because this source is much less accessible than the source of the other two contracts, I have included a copy of it at the end of this article.

## II. THE HYPOTHETICAL

Patrick Participant is an actor who is working his way up, but is not yet a "major box-office draw." He was hired in early 1986 to perform a significant, although not starring, role in a movie being produced by a major studio. Participant's contract entitled him to a \$700,000 salary and ten percent of the net profits of the film after breakeven.<sup>10</sup>

The movie, originally budgeted at \$20,000,000,<sup>11</sup> was completed in mid-1986 for \$23,000,000, which was \$3,000,000 over budget. It opened in May and fared relatively well at the box office, grossing \$40,000,000. Foreign releases grossed another \$90,000,000. In addition, 260,000 videotapes were sold to retail stores, at a wholesale price of \$57 each, thus grossing \$14,820,000. The movie will soon be sold to pay television, and later to public television stations. This will result in further revenue.<sup>12</sup>

Table 1

Budgeted production cost	\$ 20,000,000
Actual production cost	\$ 23,000,000
Revenue	
domestic box office receipts	\$ 40,000,000
foreign box office receipts	\$ 90,000,000
videotape sales	\$ 14,820,000
Total gross revenue	\$144,820,000

Patrick knows about the success of the movie and sees dollar signs flashing before his eyes. Whether or not Patrick will receive any return from his profit participation deal depends on the wording of his contract. The key to the value of the contract is how it defines the term "net profit." Each studio has several net profit participant contracts, and each

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10. Most of the money amounts in the hypothetical were derived from information obtained by calling various major studios and using average figures for a medium budget, averagely successful movie. While the studios represented that these numbers can vary greatly, they did provide some "guesstimates." The guesstimates from the studios were relatively similar to each other, which tends to enhance the reality of the hypothetical. Thus, money amounts were not chosen because they illustrated certain points most dramatically; rather they were chosen to show how these results occur with a random realistic movie deal.

11. The average budget for a studio picture is nearly \$20 million. M. WIESE, *FILM AND VIDEO MARKETING* 66 (1989).

12. For example, *Witches of Eastwick* (Warner Bros., 1987) sold to pay television for \$13 million. L.A. Times, Aug. 11, 1989, Calendar, § 6, at 1, Col. 2.

In general, pay-television rights can be sold for about \$850 million, with upward escalation based on the strength of the picture in the theatrical market. Network television sales can now pay as much as \$10 million or more for two runs. G. Stulberg, *Film Company Management*, in *THE MOVIE BUSINESS BOOK* 304 (1983).

contract defines "net" differently. Under most standard studio contracts, the movie is still losing money, at least from Patrick's point of view. However, if the SAG contract were in effect, Patrick would receive a profit from the deal.

This differentiation can be explained by comparing Patrick's results under each of the two studio contracts and under the proposed SAG contract. First, an individual analysis of each contract will illustrate how different contract formations can effect profit participants.

### III. CONTRACT I — FROM TWENTIETH CENTURY FOX, INC.

According to the Twentieth Century Fox contract, "net profits" refers to the amount of gross receipts remaining, if any, after first deducting from gross receipts, on a continuing basis, all of the following items in order: Fox distribution fees, distribution expenses, "deferments" and "gross participations" before "initial breakeven point," interest on negative cost, negative cost, "agreed overbudget deduction," "deferments" after initial breakeven point, and "gross participations" after initial breakeven point.<sup>13</sup> Further discussion is necessary in order to clarify the meanings of each of these terms.

#### A. Gross Receipts

Gross receipts are the total of all revenues derived by the studio from the exploitation of a picture in all media and territories.<sup>14</sup> According to the Fox contract, gross receipts are defined as "[t]he aggregate of gross film rentals, theatrical outright sales receipts, government subsidies, net recoveries, music publishing receipts, music recording receipts, merchandising and literary publishing receipts and net trailer income."<sup>15</sup> Fox explicitly excludes box office receipts, advances/guarantees, rebates/refunds/adjustments, subdistributor receipts, charitable contributions, collected taxes, salvage, physical properties, stock footage/featurettes/still photographs and ancillary rights from gross receipts.<sup>16</sup>

#### 1. Exclusions from Gross Receipts

The exclusions from gross receipts will be explained first, and then exactly what is included in this term.

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13. Entertainment Industry Contracts, *supra* note 7, at 28-22 to 28-23.

14. *Id.* at 28-23.

15. *Id.*

16. *Id.* at 28-27 to 28-28. These terms are explained later in the article.

*a. Box Office Receipts*

It is understandable that Fox excludes some of the listed items from gross receipts, because these items do not reflect amounts actually earned by Fox. For example, box office receipts are the total amount of money received by movie theatres from the sale of tickets for admission to the movie. Fox does not receive all of this money.<sup>17</sup> The theatres keep a large percentage of box office receipts, usually over fifty percent.<sup>18</sup> The part of box office receipts actually received by Fox is called gross film rentals. This term, and how it is calculated, will be discussed further under the section dealing with inclusions in gross receipts.

*b. Rebates, Refunds, and Adjustments*

Rebates, refunds, and adjustments are other examples of money which does not go toward Fox receipts.<sup>19</sup> Even without this clause, these amounts would probably be included in costs rather than gross receipts, because they actually are costs to Fox. Fox merely guarantees this by spelling this term out. This clause ensures that even if an amount is initially included in gross receipts, if it is later refunded in some manner, gross receipts are adjusted to reflect this.<sup>20</sup>

*c. Collected Taxes*

Collected taxes are another example of Fox's costs rather than profits.<sup>21</sup> In this part of the exceptions clause, Fox uses sales and admissions taxes as examples of collected taxes, giving the impression that the term means that sales tax and any other taxes which are included as part of the price of admission, a videotape, or other merchandise associated with the movie, will not be included as gross receipts. Since Fox does not profit from this money, it reasonably does not want to pay a percentage of this amount to a profit participant.

*d. Charitable Contributions*

It is likely that Fox excludes charitable contributions from gross receipts for the same reason it excludes collected taxes. This is another area that does not go toward Fox receipts. However, this exclusion makes less sense than the collected taxes exclusion because unlike paying

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17. Participations in the Entertainment Industry, *supra* note 9, at 13.

18. *Id.* at 13-14.

19. Entertainment Industry Contracts, *supra* note 7, at 28-27.

20. *Id.*

21. *Id.*

taxes, Fox has a choice whether or not to make charitable contributions. The participant does not have a choice of whether Fox makes these contributions; therefore it may be unfair that the participant cannot count the money earned by the picture which Fox donates to charity as gross receipts.

Also, Fox may receive tax benefits from charitable contributions, while the participant will not receive these benefits since he or she is not given any rights to the donated funds. Thus, Fox receives benefits both from receiving tax benefits for all of the donated funds and from not having to label any of the donated funds as profit from the movie.

#### *e. Subdistributor Receipts*

The net profit participant may at first glance seem unharmed by the fact that subdistributor receipts are excluded from gross receipts. There is an exception in the exclusions clause that provides that subdistributor receipts for theatrical distribution shall be included in theatre rentals for the purpose of computing net profits.<sup>22</sup> However, this exception only applies to the theatrical distribution. If Fox uses a subdistributor in any other aspect of marketing the movie, such as videotape rentals, pay television sales, or soundtrack sales, subdistributor receipts are not included in gross receipts.<sup>23</sup> This makes sense, because subdistributor receipts are not money actually earned by Fox. Fox must give the subdistributor(s) some of this money, usually in the form of a percentage of the receipts. Thus, Fox is merely stating that it will only give the participant a percentage of money that Fox actually receives as profit from the movie. However, the participant should be aware when Fox uses a subdistributor, because this affects the amount of profit Fox receives, and thus affects the amount of money the participant's percentage will be taken from.

#### *f. Advances*

While there are valid reasons for excluding the above items from gross receipts, some exclusions are not as clearly based on logical reasons. Some of these latter exclusions are crucial in explaining why profit participants often do not receive any profits from their agreements. One example is the exclusion of advances from gross receipts.<sup>24</sup> Fox's exclusion of advances from gross receipts delays the point where the movie

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22. Entertainment Industry Contracts, *supra* note 7, at 28-27.

23. *Id.*

24. *Id.*

reaches breakeven. An advance by an exhibitor means that the studio actually receives this money before it is earned at the box office. The fact that advances are excluded means that the studio does not need to credit this money toward gross receipts until it is actually earned at the box office. Until this happens, Fox retains full use of this money and the interest it earns, while this money is nonexistent as far as the participant is concerned.

The studio may claim that the advance exclusion policy is followed because some advances are "subject to adjustment," so if the movie does poorly, the studio may have to return part of the advance.<sup>25</sup> There are two flaws in this reasoning. First of all, the Fox exclusion is worded so that *all* advances fall into the exclusion, even those that are non-returnable and not subject to adjustment.<sup>26</sup> There is no good reason for the studio to have access to this money and collect interest on it without the profit participant receiving any benefit from the funds until they are actually earned. Secondly, the profits and losses of a picture are recomputed periodically.<sup>27</sup>

Thus, the studio can take the adjusted advance into account when computing that accounting period's statement. This way, the studio and the participant would both receive the benefits of the advance as long as it existed, and both would feel the effects of the loss *when* the loss occurred, if at all. The participant could have the benefit of having the advances credited to gross receipts as long as these benefits did in fact exist. This arrangement would not hurt the studio, because the advance, or any part of it relinquished, would cease to be credited to gross receipts as soon as the studio actually had to relinquish it.

#### *g. Ancillary Rights*

The Fox ancillary rights exemption denies the participant any interest in a television series, sequels, or remakes of the picture.<sup>28</sup> The exclusion of the receipts earned from ancillary rights can be a crucial loss to the participant. Soundtrack, merchandising, and musical rights are also excluded under this Fox clause, but the clause is "subject to the specific provisions set forth elsewhere in the Agreement."<sup>29</sup> For example, some receipts involved in licensing these rights *are* specifically included in gross receipts. However, the receipts earned from the rights in a televi-

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25. *Id.* at 28-8.

26. Entertainment Industry Contracts, *supra* note 7, at 28-27.

27. *Id.* at 28-37.

28. *Id.* at 28-28.

29. *Id.*



sion series, sequel, or remake of the picture are not specifically discussed elsewhere in the agreement. Thus, the participant loses a potentially valuable source of income.

This exclusion may result in financial losses since many movies are now making sequels, and many television series are based on movies.<sup>30</sup> The studios argue that sequels often make far less profit than the original, and so it is a hardship to have to pay persons involved in the first movie for sequels even if they do not participate in the sequel.<sup>31</sup> In the case of a television series based on a movie, however, there is a greater tie to the original work. Thus, the studio's case for denying the participant a portion of the profits in this instance is much weaker.

In the simplified hypothetical, assume that the gross receipts consist solely of gross film rentals. However, in the future there may be a sequel, a remake, or a television series based on the film. Patrick will not profit from any of these possibilities since the Fox contract specifically denies him rights to revenues in these cases.

*h. Stock Footage, Film and Sound Materials, Featurettes, and Still Photographs*

Fox's exclusion of all monies received from the "exploitation or use of stock footage, film and sound materials retained for library purposes, featurettes and still photographs which relate to or are derived from the Picture"<sup>32</sup> is related to the ancillary rights exclusion. Film libraries "have become one of the most valuable assets of a studio."<sup>33</sup> The movies are valuable for their "recyclation value," after their theatrical release.<sup>34</sup> Newer films, those produced in the last two or three years, are the most valuable.<sup>35</sup> In March, 1984, a West German television station agreed to pay \$85 million for the use of one-fourth of MGM's library.<sup>36</sup>

Under most studio contracts, including Fox's, the studios do not have to share these proceeds with the net profit participants.<sup>37</sup> Thus, the participants are missing out on a potentially significant source of reve-

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30. To give just one example, at last count, *Friday the 13th, Part VIII* (Paramount, 1989) was playing in the theatres and a television series of the same name was showing regularly on television.

31. Participations in the Motion Picture, Television and Music Industries, *supra* note 9, at 72.

32. Entertainment Industry Contracts, *supra* note 7, at 28-28.

33. N.Y. Times, April 3, 1984, § D, at 1, col. 3 (quoting Thomas McMeekin, an analyst with W.H. Newbold's Son & Company, a Philadelphia brokerage firm).

34. N.Y. Times, Apr. 3, 1984, § D, at 1, col. 3.

35. *Id.*

36. *Id.*

37. Entertainment Industry Contracts, *supra* note 7, at 28-28.

nue. It is not clear exactly what the rest of this exclusion encompasses, but it could include anything from selling scenes for use in rock videos to selling posters of scenes from the movie. To avoid the possibility of great financial harm, a potential participant should request clarification of this clause.

*i. Physical Properties*

The exclusion of physical properties from gross receipts is another important exclusion. Fox reserves ownership of all materials and supplies used in connection with the movie.<sup>38</sup> Any revenues it receives from the "sale, rental or other disposition" of these materials and supplies belong to Fox, and do not go toward the gross receipts of the movie.<sup>39</sup> This is true although the costs of these materials and supplies were included in negative costs.<sup>40</sup> Thus, the costs of the materials are included in the cost of the movie, but the profits from the disposal of these materials are not included in the profits of the movie.

Movie paraphernalia has a prosperous market, as evidenced by the \$15,000 that a pair of Dorothy's slippers used in *The Wizard of Oz* brought in at an auction.<sup>41</sup> At the same auction, the witch's dress sold for \$350, the witch's hat sold for \$450, the wizard's suit for \$650, and the cowardly lion's skin went for \$2,400.<sup>42</sup> Dorothy's blue-and-whiteingham dress later sold for \$1,000.<sup>43</sup> Thus, the physical properties from just one movie generated substantial profit from which, under the Fox contract, the participant would not profit.

Even items without nostalgic value can be sold as used furniture and at auctions, or used again in another picture. Such use generates revenue for the studio or saves the studio the expense of buying new materials for a later movie.<sup>44</sup> Under Fox's contract, the studio benefits from these revenues, but the participant does not.

*j. Salvage*

The salvage exclusion is very similar to the physical properties exclusion, although it may not be as valuable to the participant. This ex-

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38. *Id.* at 28-27.

39. *Id.*

40. See Entertainment Industry Contracts *supra* note 7, at 28-35.

41. A. HARMETZ, *THE MAKING OF THE WIZARD OF OZ* 304 (1977). The slippers, and other items mentioned in this paragraph, had previously been sold by MGM.

42. *Id.* at 306-308.

43. *Id.* at 306.

44. Prior to 1970, MGM sold for \$1.5 million most of the props and costumes that had been used in its pictures during the preceding forty-six years. *Id.* at 303.

clusion, like the physical properties exclusion, allows Fox to profit from the sale of items that were bought for the movie, and listed as expenses of the movie, without crediting the movies for the sale of these items. The costs of the items are included in negative cost,<sup>45</sup> while the earnings from disposal of the items are not included in gross receipts.<sup>46</sup> However, in the salvage exclusion, the possible revenues come only from scrapping or disposal of the motion picture copies or other materials, rather than from the broad authorization given under the physical properties clause.<sup>47</sup> Thus, while the same problem exists, the potential for revenue is not as great.

## 2. Defining Inclusions in Gross Receipts

### a. Gross Film Rentals

Now that the exclusions from gross receipts have been covered, it is time to discuss what is included in gross receipts. The first item listed in the Fox contract under gross receipts is gross film rentals.<sup>48</sup> Gross film rentals are defined as the aggregate of theatre rentals, four wall engagement receipts,<sup>49</sup> free-television rentals, supplemental television rentals, and non-theatrical rentals.<sup>50</sup>

In the simplified hypothetical, television sales have not yet occurred. Gross film rentals in this case are the aggregate of theatre rentals, including overseas rentals, and supplemental television rentals, which consist of the videotape distribution.<sup>51</sup> The theatre rentals are not the box-office gross. Rather, they are the amount Fox actually receives from the theatres.<sup>52</sup> The average studio retention of box office receipts is 42.5% for domestic release and 40-44% for overseas box office receipts.<sup>53</sup> Without a subdistributor for the videotapes, the entire revenues from the sale of the videotapes to the retail stores are included in gross receipts. They are included because the contract requires inclusion of "[a]ll monies actually received and earned by Distributor from the Cassette Distribution . . . of

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45. Negative Cost is defined *infra* note 93.

46. Entertainment Industry Contracts, *supra* note 7, at 28-35.

47. *Id.* at 28-27.

48. *Id.* at 28-23.

49. Four wall engagements are when the distributor rents theatres for a specific sum and keeps the profits. Entertainment Industry Contracts *supra* note 7, at 28-7.

50. *Id.* at 28-23 to 28-24.

51. The Fox definition of supplemental television rentals includes videotape sales and pay television distribution. Since the hypothetical picture has not yet been distributed to pay television, only the videotape sales portion of the clause is important for this article. Entertainment Industry Contracts, *supra* note 7, at 28-24.

52. Entertainment Industry Contracts, *supra* note 7, at 28-8.

53. *Id.* at 28-14.

the Picture.”<sup>54</sup> Using the 42.5% figure for domestic release and 42% for overseas release, gross film rentals are as follows:

Table 2

Domestic theatre rentals	\$40,000,000 x 42.5%	= \$17,000,000
Foreign theatre rentals	\$90,000,000 x 42%	= 37,800,000
<u>Videotape distribution</u>		<u>14,800,000</u>
Gross film rentals		<u>\$69,600,000</u>

In the simplified hypothetical, gross film rentals equal gross receipts, because the other elements of gross receipts — theatrical outright sales receipts, government subsidies, net recoveries, music publishing receipts, music recording receipts, merchandising and literary publishing receipts and net trailer income — are considered to be nonexistent. This is a common scenario in a movie that does not release a soundtrack or have great merchandising appeal.<sup>55</sup> However, even in the simple hypothetical, at least one of these items may later become important — net recoveries<sup>56</sup> — because lawsuits may arise for various reasons, and, depending on the participant’s contract, money judgments in these suits may or may not affect the participant.

#### b. Net Recoveries

The Fox contract includes in gross receipts all revenues from any settlement or court judgment or decree relating to any claims for “unauthorized exhibition, distribution or other use of the Picture and/or for any infringement, plagiarism or other interference by any Party with the Copyright of the Picture” or for “breach of contract in connection with the distribution and/or exhibition of the Picture.”<sup>57</sup> Thus, any money received from such litigation, minus “costs and expenses incurred in connection with obtaining such monies, including reasonable attorney’s fees” are included in gross receipts.<sup>58</sup> However, if the expenses are greater than the money received, this loss is included in the costs of the picture. Thus, this clause is a double-edged sword.<sup>59</sup> Under Fox’s participation

54. *Id.* at 28-24.

55. This is true of most movies. The majority of movies do not release soundtracks. Merchandising was largely ignored until the huge success of *Star Wars*, whose products have grossed over \$1 billion at the retail level from merchandising rights worldwide. Blum, *Merchandising*, in *THE MOVIE BUSINESS BOOK* at 379 (1988).

56. The term “net recoveries” is defined *infra*.

57. Entertainment Industry Contracts, *supra* note 7, at 28-24 to 28-25.

58. *Id.* at 28-4 to 28-5.

59. However, the studio will probably not spend more defending these suits than it stands to gain, since it, too, hopes to profit from these lawsuits. Thus, unless the studio miscalculates

contract, almost any litigation involving the movie will affect the profitability of the picture from the participant's point of view as well as from the studio's.

### *B. Distribution Fees*

Distribution fees are percentage charges on incoming film rentals from the various markets.<sup>60</sup> They are service fees for the sale of the movie to these markets.<sup>61</sup> Fox charges a distribution fee of 30% of gross film rentals on domestic theatre rentals, 37.5% on rentals in England and Continental Europe, and 40% on other international rentals.<sup>62</sup> Its percentage charge for distribution in England is a little higher than the average charge of 35%, but its charges for domestic and other international distribution are about average.<sup>63</sup> Since studios normally do not distinguish Continental European distribution from other international rentals,<sup>64</sup> the Fox contract gives the participant a better deal in this area. This makes up for the disadvantage of the higher England charges. In the Patrick hypothetical, assume that the international rentals are evenly split between England and Continental Europe on the one hand and other international rentals on the other (\$18.9 million each). Assume also that videotape rentals are divided almost evenly among the three areas, with domestic videotape sales at \$4.8 million and European and other international videotape sales each at \$5 million.

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on the profitability of a suit or the strength of its claim, the participant should not be harmed by this clause.

60. A. D. Murphy, *Distribution and Exhibition: An Overview*, in *THE MOVIE BUSINESS BOOK* 256 (1988).

61. *Id.*

62. Entertainment Industry Contracts, *supra* note 7, at 28-28.

63. A. D. Murphy, *Distribution and Exhibition: An Overview*, in *THE MOVIE BUSINESS BOOK* at 256-57 (1988).

64. *Id.* at 257.

Table 3

Domestic theatre rentals	\$17,000,000	
Domestic videotape sales	<u>4,800,000</u>	
Domestic film rentals	<u>\$21,800,000</u>	
	<u>× 30%</u>	
Domestic distribution fee		\$ 6,540,000
European theatre rentals	\$18,900,000	
European videotape sales	<u>5,000,000</u>	
European film rentals	<u>\$23,900,000</u>	
	<u>× 37.5%</u>	
European distribution fee		\$ 8,962,500
Other International theatre rentals	\$18,900,000	
Other International videotape sales	<u>5,000,000</u>	
Other International film rentals	<u>\$23,900,000</u>	
	<u>× 40%</u>	
Other International distribution fee		\$ 9,560,000
Total distribution fees		<u><u>\$25,062,500</u></u>

### C. Videotape Sales

An interesting element in the Fox contract is the way it treats videotape sales, in terms of both calculating gross receipts and determining distribution fees on these sales. The way Fox treats these sales has been explained above, in the appropriate sections.<sup>65</sup> However, it is easier to explain why this treatment of videotape sales is unique in a separate section. This way the interplay between the clauses referring to the inclusion of videotape sales in gross film rentals and the clauses referring to distribution fees can be more clearly shown. As mentioned earlier, Fox considers videotape sales to be part of supplemental television rentals, and thus part of gross film rentals.<sup>66</sup> Therefore, under the contract, all monies received by Fox from videotape sales are included in gross receipts. Also, because the videotape sales are part of gross film rentals, under the contract they are treated the same as theatre rentals in determining Fox's distribution fee. This is a very unusual approach.

Generally, videotape sales fees are paid as a royalty added into gross receipts.<sup>67</sup> The usual royalty rate is 20% of the wholesale selling price of the cassette.<sup>68</sup> After this royalty is added to gross receipts, a distribution

65. See *supra* note 50 and note 60.

66. See *supra* note 50 Gross Film Rentals; Entertainment Law Contracts *supra* note 7, at 28-24.

67. Entertainment Industry Contracts, *supra* note 7, at 28-16.

68. *Id.*

fee is charged on the royalty.<sup>69</sup> The distribution fee is often 30% for domestic distribution and 40% for foreign distribution.<sup>70</sup>

Fox's system of including videotape sales in gross receipts and calculating distribution fees is more favorable to the participant than the usual method, mainly since 100% of wholesale sales are included in gross receipts rather than 20%. Another beneficial factor for the profit participant is that while Fox's distribution fees are similar to those normally charged by many major studios, Fox divides foreign distribution into two categories: European and foreign. The European distribution fee of 37.5% is lower than the typical 40% videotape distribution fee for foreign distribution.<sup>71</sup> It is important to keep in mind that while the studios typically charge a 40% distribution fee for foreign sales of videotapes, this 40% charge is only charged on the 20% of the wholesale selling price of the videotapes which the studios credit to gross receipts. Fox charges its 37.5% distribution fee on the entire wholesale price of the videotapes, because this price is the figure Fox studio credits to gross receipts. However, the Fox approach to treating revenues from videotape sales is still much more beneficial to the net profit participant than the typical studio approach.

#### D. Distribution Expenses

After deducting distribution fees from gross receipts, Fox next deducts distribution expenses. Distribution expenses are deductions to cover direct costs of marketing a film.<sup>72</sup> The largest expenses in this area are print costs and advertising.<sup>73</sup> The rule of thumb for 35mm prints during most of the year is to have a count of 1,100 prints.<sup>74</sup> This is the amount printed in our hypothetical. Each print costs about \$1,200 to make.<sup>75</sup> Thus, the prints cost \$1.32 million. The video cassettes cost \$5.00 each to duplicate.<sup>76</sup> At 260,000 units, the total cost for this is \$1,300,000. Advertising ran about \$5 million to open the picture,

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69. *Id.*

70. *Id.*

71. Entertainment Industry Contracts, *supra* note 7, at 28-28.

72. A. D. Murphy, *Distribution and Exhibition: An Overview*, in THE MOVIE BUSINESS BOOK 256 (1988).

73. Entertainment Industry Contracts, *supra* note 7, at 28-17.

74. This information was obtained through polling studio representations of average print counts. This number is well within the 1,000 - 1,500 print count estimate for a saturation booking set forth in Myers, *The Studio as Distributor*, in THE MOVIE BUSINESS BOOK 278 (1988).

75. Again, this was obtained by polling the studios, which is close to the \$1,000 figure set forth in Myers, *The Studio as Distributor*, in THE MOVIE BUSINESS BOOK 278 (1988).

76. Again, this was obtained by polling the studios.

which is a realistic amount for the time of year it opened.<sup>77</sup> Total advertising costs for the theatrical release reached \$10 million.<sup>78</sup> Fox then charges a 10% overhead fee on advertising expenses.<sup>79</sup> This is standard practice for distributors.<sup>80</sup> The overhead charge, added to the base expenses, brings the total to \$11 million. Marketing costs for the videotape reached about 15% of total gross or 15% of \$14,820,000, which is \$2,223,000. Thus, total advertising and print costs reached \$15,843,000.<sup>81</sup>

Distribution expenses are not subject to the overhead to which, as will be shown, production costs are subject. However, as shown above, the advertising expense is subject to a 10% overhead charge. This figure may exceed actual overhead charges.<sup>82</sup> To avoid this possibility, a participant should try to negotiate a ceiling to this overhead allocation.<sup>83</sup>

While the \$15,843,000 figure covers the costs of the most expensive factors in the hypothetical, there are many other items included in distribution expenses. Fox lists these as conversion/transmission costs, taxes, checking costs, collection costs, trade association fees, guild payments, insurance costs, copyrighting costs, copyright infringement costs, claims and litigation costs, industry assessments, quota losses, and subdistributor distribution costs. And, just in case the studio forgot to mention some cost, they add miscellaneous distribution costs to the list.<sup>84</sup> These items are beyond this article's scope and thus shall not be discussed further. For a conservative estimate, \$1 million could be added to distribution expenses to cover these items, bringing the grand total for distribution expenses to \$16,843,000.

### E. "Deferments" and "Gross Participations"

Gross participations are participations calculated as a percentage of gross receipts earned by the distributor.<sup>85</sup> Deferments are gross participations which vest after a certain amount of time or after the movie reaches a specified receipt or profit level.<sup>86</sup> While salaries are included

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77. *Id.*

78. Again, this figure was arrived by polling the studios for realistic numbers.

79. Entertainment Industry Contracts, *supra* note 7, at 28-32.

80. Participations in the Entertainment Industry, *supra* note 9, at 18.

81. This figure is reached by adding the print costs, video cassette costs, advertising costs, and marketing costs together — \$1,320,000 + \$1,300,000 + \$11,000,000 + \$2,223,000 = \$15,843,000.

82. Entertainment Industry Contracts, *supra* note 7, at 28-18.1.

83. *Id.*

84. *Id.* at 28-29 to 28-34.

85. *Id.* at 28-22.

86. *Id.*



within production costs of the movie (negative cost),<sup>87</sup> gross participations and deferments are not included.<sup>88</sup> The producer and the BIG stars in a movie may receive a gross participation in the movie. The gross participations can start paying off either from the first day the movie starts making money, or can be deferred until the movie makes a certain amount of money. This deferment can be until the movie reaches breakeven,<sup>89</sup> initial breakeven,<sup>90</sup> or some other point chosen in negotiations.<sup>91</sup> Other parties may also receive deferments for rights, services, materials, or facilities granted or used in connection with the picture. As was recently written in the Washington Post, "net profits generally don't kick in when there are gross profit participants. 'What it really depends on,' says one top agent, 'is if you've got big stars. If you're getting into a movie with Eddie Murphy, that diminishes your opportunity.'" <sup>92</sup>

In our case, the producer and the main star each have participation agreements for 4% of the gross receipts which start earning as soon as the movie does. Thus, to date, each has received \$2,784,000 (4% of \$69,600,000), in addition to their original salaries. Other deferments total 1% of the gross profits, or \$696,000. These result in another \$6,264,000 being deducted from gross receipts before Patrick Participant's share is determined.

#### F. Negative Cost

The negative cost of a movie is its production cost.<sup>93</sup> Fox divides production cost into direct charges and overhead charges.<sup>94</sup> The direct cost of the hypothetical movie is \$20 million. Included in this amount are salaries, location costs, filming costs, dubbing costs, and subtitling costs, to name the major charges.<sup>95</sup> In addition, Fox charges an overhead charge of 15% of direct charges.<sup>96</sup> This is a typical studio overhead

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87. Entertainment Industry Contracts, *supra* note 7, at 28-35.

88. *Id.* at 29-23.

89. Breakeven is the point when revenues equal deductions. D. LEEDY, MOTION PICTURE DISTRIBUTION: AN ACCOUNTANT'S PERSPECTIVE 57 (1980).

90. Initial breakeven is the first time a picture reaches breakeven. Since a picture may reach breakeven in one accounting period but drop below breakeven in the next, initial breakeven can be different from breakeven.

91. A participation contract may provide that breakeven occurs at actual breakeven or the contract may state an arbitrary breakeven point, such as two and one half (2 1/2) times the negative cost of the picture. Entertainment Industry Contracts, *supra* note 7, at 28-11.

92. The Wash. Post, Mar. 26, 1990, at B9, col. 5.

93. Thus, the \$23 million figure for production costs I gave in the hypothetical actually represents the negative cost of the picture.

94. Entertainment Industry Contracts, *supra* note 7, at 28-34.

95. *Id.* at 28-35.

96. *Id.*

charge.<sup>97</sup> In our case, this charge amounts to \$3 million (15% of \$20 million). Thus, the negative cost of the movie is actually \$23 million.

### G. Interest on Negative Cost

Fox charges interest on negative cost "commencing as of the week in which an amount chargeable to [n]egative [c]ost is incurred and continuing until the end of the [s]tatement [p]eriod with respect to which such amount chargeable to [n]egative [c]ost is recouped."<sup>98</sup> The only statement period mentioned in Fox's contract is the participation statement period.<sup>99</sup> The length of this period varies. The first statement is due within six months of the initial release date of the picture and then statements are due every three months for the next two years.<sup>100</sup> After that, statements are due every six months for another two years, then annual statements are required.<sup>101</sup>

The fact that Fox charges interest as of the week the cost is incurred rather than at the time it actually pays for the expenses favors Fox over the profit participant, because Fox records these amounts as costs although it still actually has the funds.<sup>102</sup> Fox thus has use of, and collects interest on, some of the funds attributed to negative cost, while as far as the participant is concerned, this money has been spent. Also, Fox does not stop charging interest on negative costs when the amount chargeable to negative cost is actually recouped. Instead, it charges interest until the end of the statement period in which the amount chargeable to negative cost is recouped. This favors Fox, since again Fox has the use of this money for some time while, as far as the participant is concerned, this money is nonexistent.<sup>103</sup> Fox both has the money and charges interest on negative cost for not having the money until the end of the statement period, which could be as long as a year.<sup>104</sup>

Another factor favoring Fox is that because Fox considers its over-

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97. *Id.* at 28-18.2.

98. *Id.* at 28-22.

99. Entertainment Industry Contracts, *supra* note 7, at 28-37. The contract also mentions a negative cost statement, but this statement is only prepared once, and there is no statement period mentioned, except "[a]s soon as practicable after delivery of the final corrected answer print of the Picture." *Id.*

100. *Id.*

101. *Id.*

102. Entertainment Industry Contracts, *supra* note 7, at 28-18.1.

103. *Id.*

104. The longest period between participation statements is a year, so if this time period between participation statements is in effect (after the picture has been released for over 4 1/2 years), and Fox recoups the money right after one statement has been rendered, it does not have to stop charging interest on it until the next statement is rendered, a year later.

head on negative cost to be part of negative cost, it charges its interest on negative cost on a figure including its overhead. Fox actually charges interest on its overhead. The 15% overhead charge may more than cover actual overhead to begin with, and this additional charge leads to further profit for Fox.

The studio charges "an annual percentage rate one-half of one percent ( $1/2\%$ ) above the prime interest rate charged by The First National Bank of Boston from time to time in effect, plus a charge of twenty percent (20%) on said annual percentage rate to cover compensating balances."<sup>105</sup> The prime interest rate charged by The First National Bank of Boston is currently 10.5% (as of Thursday, December 21, 1989).<sup>106</sup> Thus, Fox charges 11%, plus a charge of 20% on this percentage rate.

For example, assume Fox charges 13.2% interest (11% plus 20% of 11%). If the prime interest rate was constant, and all expenses were paid off in one statement period, most of the initial expenses would be charged interest for at least six months (until the first statement due date). Thus, the initial \$23 million would accrue \$1,518,000 in interest. Actually, the expenses are not considered paid off until the movie reaches breakeven, which could take years. Therefore, throughout these years, Fox is continually charging interest, pursuant to this contract, on the amount that is not yet paid off. Interest is recouped first, leaving the balance to accrue additional interest.<sup>107</sup> For a conservative figure, \$2,450,000 will be attributed to the hypothetical for interest on negative cost to date.

### *H. Agreed Overbudget Deduction*

According to the Fox contract, agreed overbudget deduction is "an amount equal to the sum by which the [n]egative [c]ost exceeds the [b]udgeted [n]egative [c]ost plus a contingency allowance of 10% of the initial \$1.5 million of the [b]udgeted [n]egative [c]ost and 5% of the [b]udgeted [n]egative [c]ost in excess of \$1.5 million."<sup>108</sup> The wording of this statement indicates the agreed overbudget deduction is tied to the cost of the movie, in addition to the amount the movie runs over the budgeted negative cost. The overbudget deduction includes the 10% contingency allowance of 5% of the budgeted negative cost over \$1.5

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105. Entertainment Industry Contracts *supra* note 7, at 28-22.

106. Telephone Interview with The First National Bank of Boston (Dec. 21, 1989). A recording stated that the prime rate of The First National Bank of Boston was  $10 \frac{1}{2}\%$  as of July, 1989.

107. This is apparent because the contract states that the following amount in order of priority set down below will be deducted from net profits, and interest on negative cost is listed before negative cost.

108. Entertainment Industry Contracts, *supra* note 7, at 28-22 to 28-23.

million. Thus, if the actual amount over budget remains constant, the higher the original budget for the movie, the lower the overbudget penalty percentage. This takes into account that with a higher original budget, unforeseen costs are also likely to be higher. However, it does not take into account the fact that a net profit participant is being penalized for something over which he probably has no control. In the hypothetical, the budgeted negative cost of the movie was \$20 million. Thus, although the movie was produced at just \$3,000,000 over budget, the agreed overbudget deduction would be:

Table 4

Negative cost	\$23,000,000	
— Budgeted negative cost (BNC)	<u>(20,000,000)</u>	3,000,000
10% of \$1,500,000	150,000	
5% of BNC over \$1,500,000	<u>925,000</u>	
		<u>(1,075,000)</u>
Agreed overbudget deduction		<u><u>\$1,925,000</u></u>

### I. Calculating Net Profits

To calculate the net profits, subtract the total of all of the items listed above from gross receipts:

Table 5

Total <sup>1</sup> distribution fees	\$25,062,500
Distribution expenses	16,843,000
Gross participations and deferments	6,264,000
Negative cost	23,000,000
Interest on negative cost	2,450,000
<u>Agreed overbudget deduction</u>	<u>1,925,000</u>
Total deductions from gross receipts	\$75,544,500
Gross receipts	\$69,600,000
-Total deductions from gross receipts	<u>75,544,500</u>
Net profits	<u><u>(\$ 5,944,500)</u></u>

These figures illustrate that the movie is still losing \$5,944,500. Also, realize that while revenues are still mounting, so are expenses, especially the gross profit participations that continue to receive a share of the gross revenues. Thus, a lot more than \$5,944,500 in revenue must be received by Fox for the picture to reach breakeven, and thus for Patrick to receive any revenue from his profit participation contract.

### J. General Accounting Provisions

A couple of Fox's general accounting provisions affect the profit participant. First, the contract provides that no monies shall be included in gross receipts unless received by the distributor in United States dollars in the United States.<sup>109</sup> Patrick Participant receives no percentage of the money sitting in overseas banks as a result of overseas sales, until it is transferred to banks in the United States. This provision further delays the point where the movie reaches breakeven. Even after breakeven, Patrick does not receive back interest on this money. However, the contract does provide that "[a]ll [g]ross [r]eceipts received by [d]istributor in a foreign currency will be converted into United States Dollars and remitted to Fox in the United States as promptly as applicable [l]aws will permit."<sup>110</sup> This ensures that Fox will not hold the money in overseas accounts indefinitely, and that the money will be added to gross receipts as quickly as it can be transferred to the United States. While the participant would benefit further if the money was credited to gross receipts as soon as it was earned regardless of the currency, the harmful effects of this clause are lessened by Fox's promise to transfer the funds to the United States as quickly as is legally possible.

Another notable Fox practice is that Fox reserves a right of first refusal to acquire the participant's participation.<sup>111</sup> This clause prevents a participant from selling or assigning his participation until he has given Fox ten days to exercise this right. While this clause normally does not result in a monetary loss to the participant, it is a restriction, because it may prevent the participant from transferring the participation to the person of his or her choice. Some studio contracts allow the participations to be freely assignable.<sup>112</sup>

## IV. CONTRACT 2 — FROM WARNER BROTHERS, INC.

The Warner Brothers formula for calculating net profits is similar to Fox's in many ways. Therefore, rather than analyze the entire Warner Brothers contract, the following sections will evaluate the important similarities and differences between the two contracts.

### A. Gross Receipts

Warner Brothers defines gross receipts similarly to the Fox defini-

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109. *Id.* at 28-36.

110. *Id.*

111. *Id.* at 28-42.

112. Entertainment Industry Contracts, *supra* note 7, at 28-60.

tion, but there is a stylistic difference, as well as some important substantive differences. Stylistically, the Warner contract does not contain a list of exclusions from gross receipts; however, of course, anything not explicitly included under gross receipts is implicitly excluded. This makes the exclusions even harder for an unwary profit participant to discern. At least with the Fox contract, the studio states the exclusions clearly in the contract, so the participant has a better chance of realizing what he or she is giving up.

When a subdistributor is involved, Warner includes in gross receipts "either: (i) the film rentals received by such subdistributor from exhibitors which Warner accepts for the purpose of its accountings with such subdistributor; or (ii) Warner's share (actually received) of film rentals received by such subdistributor; whichever Warner elects from time to time as to each subdistributor."<sup>113</sup> Clause (i) does not mean that Warner includes all subdistributor receipts in gross receipts. Rather, clause (i) allows Warner to choose to include the portion of film rental money from exhibitors that the subdistributor credits to Warner under its agreement with the studio. Clause (ii) allows Warner to choose an alternative method of calculating subdistributor receipts into gross receipts — by including the money Warner has actually received from the subdistributor in gross receipts.

At first glance, the subdistributor clause and the other clauses under gross receipts seem to differ from Fox's contract in that Fox requires that the money be "received and earned" before being included in gross receipts,<sup>114</sup> while Warner only requires that the money from film rentals be "actually received."<sup>115</sup> However, Warner's definition of film rentals, found later in the contract, includes the requirement that "[u]ntil earned, forfeited or applied to the Picture, neither advance payments nor security deposits shall be included in film rentals."<sup>116</sup> Thus, although it seems that advances and guarantees under Warner's contract should be included in gross receipts when received rather than when earned (which would favor the participant), the two studio contracts are virtually identical in this respect.

While Fox specifically includes all monies earned after expenses from copyright infringement of the picture and from breach of contract actions connected with the picture in gross receipts, Warner only lists recoveries from copyright infringement suits as included in gross re-

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113. *Id.* at 28-53.

114. *Id.* at 28-23.

115. *Id.* at 28-53.

116. Entertainment Industry Contracts, *supra* note 7, at 28-58.

ceipts.<sup>117</sup> In this respect, the Fox contract favors the participant more than the Warner contract. However, both studios include government subsidies in gross receipts and exclude charitable contributions and by exclusion, both studios seem to exclude salvage, physical properties, stock footage, and ancillary rights from gross receipts.

### B. Distribution Fees

Warner Brothers, like Fox, charges a 30% distribution fee on domestic and a 40% distribution fee for other international rentals.<sup>118</sup> On rentals in England, however, Warner Brothers charges 35% as opposed to Fox's 37.5%.<sup>119</sup> If rentals in England comprise half of the total European rentals (\$9,450,000), Warner Brothers' fee on these rentals would be \$3,307,500 as opposed to Fox's \$3,543,750. Thus, under Warner Brothers' contract, the distribution fees would be \$19,511,250, which is \$236,250 less than under Fox's.

### C. Videotape Sales

Another important substantive difference between the studio contracts is the way they treat videotape sales. With respect to videotapes, Warner follows the more usual method of including in gross receipts an amount equal to 20% of the gross wholesale rental and sales income, less a reasonable allowance for returns.<sup>120</sup> Remember that Fox included in gross receipts all monies received from videotape sales and rentals. Under the Warner Brothers contract, only 20% of the \$14,800,000 grossed from videotape distribution, or \$2,960,000, is included in gross receipts, rather than the entire amount. The result is gross receipts of \$57,760,000 rather than \$69,600,000 under the Fox contract.

### D. Distribution Expenses

There are no major differences in the way Warner Brothers and Fox calculate distribution expenses.<sup>121</sup>

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117. *Id.* at 28-53.

118. Warner's distribution fees shall be as follows:

- (a) 30% of the gross receipts of the Picture derived by Warner from all sources in the United States and Canada.
- (b) 35% of the gross receipts of the Picture derived by Warner from all sources in the United Kingdom.
- (c) 40% of the gross receipts of the Picture derived by Warner from all sources other than those referred to in (a) and (b) above . . . .

Entertainment Industry Contracts, *supra* note 7, at 28-54.

119. *Id.* at 28-54.

120. *Id.* at 28-53.

121. The Warner contract covers distribution expenses. *Id.* at 28-54 to 28-58.

### E. "Deferments" and "Gross Participations"

There are no major differences in the way Warner Brothers and Fox treat deferments and gross participations.<sup>122</sup>

### F. & G. Negative Cost and Interest on Negative Cost

The two studios compute negative cost in a similar manner.<sup>123</sup> However, they use different interest rates. While both studios tie their interest rates to the prime rate of The First National Bank of Boston, Warner Brothers charges 125% of this interest rate, and the interest starts accruing on the day that item is charged to the picture.<sup>124</sup> Thus, Warner Brothers currently charges 13.125% interest. Charging this on the initial \$23 million over six months, the interest would be \$1,509,375, which is \$8,625 less than Fox's. Although this amount seems insignificant in relation to the other figures discussed here, over time this would become a significant amount. Assume that by now this interest rate cut \$30,000 from the negative balance.

### H. Agreed Overbudget Deduction

Warner Brothers' overbudget deduction calculations call for an amount equal to the amount by which the final direct cost exceeds 105% of the budgeted direct cost to be added to the actual cost of production.<sup>125</sup> In our case, the budgeted cost was \$20 million and the final direct cost was \$23 million. 105% of budgeted cost is \$21 million. The final costs exceeds this figure by \$2 million. Thus, \$2 million must be added to the actual cost of production. This is \$75,000 higher than Fox's \$1,925,000 deduction, so this term of the contract would result in \$75,000 more to be deducted from gross receipts than the corresponding term in Fox's contract.

### I. Calculating Net Profits

Thus, with a few changes in the terms of the contract, the movie ends up losing even more money:

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122. The Warner contract covers deferments and gross participations under distribution expenses rather than setting up a separate subheading and section to cover these, but the result is the same — these are deducted from gross receipts, thus delaying breakeven for the net profit participant. *Id.* at 28-58.

123. The Warner contract covers negative cost and interest on negative cost in Entertainment Industry Contracts *supra* note 7, at 28-60 to 28-62.

124. *Id.* at 28-61.

125. *Id.*



Table 6

Total distribution fees	\$19,511,250
Distribution expenses	15,843,000
Gross participations and deferments	6,264,000
Negative cost	23,000,000
Interest on negative cost	2,420,000
<u>Agreed overbudget deduction</u>	<u>2,000,000</u>
Total deductions from gross receipts	\$69,038,250
Gross receipts	\$57,760,000
<u>— Total deductions from gross receipts</u>	<u>(69,038,250)</u>
Net profits	<u>(\$11,278,250)</u>

### J. General Accounting Provisions

Comparing Warner Brothers' general accounting provisions with those mentioned in the Fox contract, Warner's policy regarding overseas money is similar to Fox's, with one important difference — Warner's contract does not require that the overseas money be converted into United States dollars and remitted to Warner in the United States as soon as possible.<sup>126</sup> Theoretically, Warner could leave this money in foreign banks indefinitely. However, Warner must credit the money to gross receipts while it is still overseas if it uses the money on an exportable film or to purchase exportable personal property.<sup>127</sup> Also, at the written request and expense of the participant, both studios will transfer any amount of overseas funds which would otherwise be due the participant to a bank or designated party in the country involved.<sup>128</sup> The way the Warner contract is worded, it seems that the overseas money terms are meant to apply to money which cannot yet be legally converted to United States dollars and remitted to the United States. The participant should be aware that this is not specified in the clause.

Unlike the Fox contract, the Warner Brothers contract provides that the profit participation deal is freely assignable, with a few conditions.<sup>129</sup> The conditions are that the participant must sign a Notice of Irrevocable Authority, that both parties must sign a Distributor's Acceptance Form, and that if there are more than three assignees Warner may have a disbursing agent appointed to handle the dividing of Warner's payments on the agreement.<sup>130</sup>

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126. Entertainment Industry Contracts, *supra* note 7, at 28-59 to 28-60.

127. *Id.*

128. *Id.* at 28-60.

129. *Id.* at 28-65.

130. *Id.*

## V. THE SCREEN ACTORS GUILD PROPOSED CONTRACT

Since many of the terms of the Screen Actors Guild's (SAG's) proposed profit participation contract are similar to the terms in the two major studio contracts, this article explains how the SAG contract differs from the studio contracts, rather than looking at each term of the contract in detail.

### A. Gross Receipts

Like Fox's contract, but unlike Warner Brothers', the SAG proposed contract includes all money received by the distributor from videotape distribution in gross receipts.<sup>131</sup> In addition, the SAG contract does not provide for an overbudget deduction. All three contracts define gross receipts in a similar fashion, although each defines some of the components which make up gross receipts differently.<sup>132</sup>

### B. Distribution Fees

The SAG's proposed profit participation contract contains lower distribution fee allowances than either studio's contract.<sup>133</sup> The SAG contract allows a 25% distribution fee for domestic film rentals, as compared to the 30% fee charged by the studios.<sup>134</sup> For film rentals in England, the SAG contracts allow a 30% fee,<sup>135</sup> while Warner charges 35%<sup>136</sup> and Fox charges 37.5%.<sup>137</sup> While Fox charges a distribution fee of 37.5% of gross film rentals in continental Europe<sup>138</sup> and both studios charge a fee of 40% on other international rentals,<sup>139</sup> the SAG contract calls for a fee of only 35% for foreign film rentals outside England.<sup>140</sup>

### C. Videotape Sales

The SAG contract proposes a 10% fee for videotape distribution.<sup>141</sup> This 10% fee is charged on all money received by the distributor from

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131. Participations in the Entertainment Industry, *supra* note 9, at 357.

132. The SAG contract defines gross receipts. *Id.* at 356-57.

133. *Id.* at 358. There is an exception for receipts from a license for domestic network television exhibition, for which the SAG contract does not allow a fee, but this exception does not concern us here (yet), since our hypothetical movie has not been sold to network television.

134. *Id.*

135. *Id.*

136. Entertainment Industry Contracts, *supra* note 7, at 28-54.

137. *Id.* at 28-28.

138. *Id.*

139. *Id.* at 28-28, 28-54.

140. Participations in the Entertainment Industry, *supra* note 9, at 358.

141. *Id.*

videotape distribution in gross receipts.<sup>142</sup> The SAG 10% distribution fee for videotape sales is much lower than Fox's 30% on domestic sales, 37.5% on sales in England and continental Europe, and 40% on other international sales.<sup>143</sup>

While the SAG 10% distribution fee on videotape sales is lower than Warner's fees, the Warner distribution fee is charged on only 20% of the wholesale sales income. Thus, the overall amount collected by Warner for videotape distribution fees is lower than that collected under the SAG contract. Warner makes up for this at the other end, since it does not credit gross receipts with most of the income from the sales in the first place. Overall, the SAG treatment of videotape sales is more favorable to the profit participant than the comparative terms in either of the studio contracts. The SAG distribution fees are as follows:

Table 7

Domestic film rentals	$\$17,000,000 \times 25\% = \$ 4,250,000$
England film rentals	$\$ 9,450,000 \times 30\% = 2,835,000$
Other foreign film rentals	$\$28,350,000 \times 35\% = 9,922,500$
<u>Videotape distribution</u>	$\$14,800,000 \times 10\% = 1,480,000$
Total distribution fees	<u>18,487,500</u>

This results in a savings of \$1,260,000 in fees over the Fox contract and \$1,023,750 over the Warner Brothers contract.

#### D. Distribution Expenses

The SAG contract stipulates that distribution costs "shall be determined after all related rebates and/or discounts granted Distributor, whether the discounts and/or rebates are based on total volume or otherwise determined."<sup>144</sup> This term requires that the studios give the participant the benefits of discounts given to the studios by deducting the amount of the discounts from the distribution costs. The major studio contracts do not have such a provision, and so the studios alone benefit from these discounts. This presents a problem in the case of volume discounts. The studios claim that because the discount would not be earned by one movie, the benefits received due to the studio using certain facili-

142. *Id.* at 357-58.

143. As discussed above, because Fox treats videotape sales as part of gross film rentals, Fox's distribution fees on videotape sales are the same as its distribution fees on other film rentals.

144. Participations in the Entertainment Industry, *supra* note 9, at 358.

ties for many movies should not be passed on to these movies.<sup>145</sup> The Fox and Warner Brothers contracts allow the studios to pocket these discounts and rebates, without passing any benefits on to the participants. The SAG contract, by requiring that these discounts be figured into the distribution costs of the movies, may cause the reduction of total distribution expenses by thousands of dollars. Here, assume that this clause resulted in a savings of \$30,000 in print fees.

The SAG contract provides that actual advertising overhead be charged as part of the distribution costs.<sup>146</sup> This provision differs from that of the two major studio contracts which provide for an overhead charge of 10% of direct advertising costs. As mentioned earlier, this provision is likely to be favorable to the profit participant, since the actual advertising overhead is likely to be less than 10% of direct charges. It is unclear how much a participant will save under this clause, because the actual definition of overhead is not established.

Since the SAG contract does allow the studio to count actual advertising overhead charges in distribution expenses, the studio would not lose money under this term. If it profits less, it would be because the 10% charge on direct advertising it currently uses to arrive at advertising overhead costs does not actually reflect these costs accurately, and errs in favor of the studio. Such a loss of profit to the studio does not seem unfair.

#### E. "Deferments" and "Gross Participations"

The SAG contract provides a cap on deductions for gross participations.<sup>147</sup> The contract states, "[t]he total amount deductible by reason of payment to gross profit participants shall be limited so that the net profits herein shall not be reduced by more than 10% of the amount that would have been otherwise determined as net profits herein were there no gross profit participants."<sup>148</sup> This is an important cap. Under this clause, as soon as the movie shows a profit before subtracting gross participations, the net participant likewise begins to profit. In the studio contracts, which have no such clause, the gross participant's share continues to grow as the movie continues to make money. This can greatly delay the breakeven point of the movie. Under the SAG contract, movies could reach breakeven much more quickly.

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145. Entertainment Industry Contracts, *supra* note 7, at 28-18.

146. Participations in the Entertainment Industry, *supra* note 9, at 359-60.

147. *Id.* at 363.

148. *Id.*

### F. Negative Cost

As far as direct costs are concerned, the SAG contract does not limit this category any more than do the studio contracts.<sup>149</sup> However, where overhead is concerned, the SAG contract differs greatly from the studio contracts. The SAG contract calls for actual overhead costs that are reasonably related to the picture to be charged by the distributor, rather than allowing for a flat percentage.<sup>150</sup> This is similar to SAG's treatment of advertising overhead, discussed above. However, in the case of overhead on direct negative cost charges, this overhead charge may not exceed 10% of direct charges.<sup>151</sup> Unlike the advertising overhead provision, this provision guarantees that the participant will save at least 5% of direct charges, since the studio contracts each provide for a 15% overhead charge. For Patrick Participant, that means that overhead may not exceed \$2 million. Thus, even if the distributor charged the maximum allowable overhead, this figure would still be \$1 million less than under the studio contracts.

### G. Interest on Negative Cost

An important difference between the major studios and the SAG proposed contract is the manner in which the contracts dictate that interest be determined. The SAG contract calls for an interest rate *equal* to the prime commercial rate of The First National Bank of Boston.<sup>152</sup> Thus, interest would now be calculated at 10.5%, rather than Fox's 13.2% or Warner Brothers' 13.125%. Over six months, interest on \$23 million would total \$1,207,500, a savings of \$310,500 over the Fox contract and \$301,875 over the Warner Brothers contract. In the hypothetical, the savings could total over a half million dollars.

In addition to the important change in the terms of the interest on negative cost, the SAG contract calls for an accounting period of one month.<sup>153</sup> This term allows negative cost to go off the books faster than under the two studio contracts, resulting in even further savings.<sup>154</sup> Interest is not calculated until the distributor actually pays for the item included in production cost.<sup>155</sup> Although it is hard to quantify the sav-

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149. The SAG contract discusses negative cost under the label of "Cost of Production." *Id.*

150. *Id.*

151. Participations in the Entertainment Industry, *supra* note 9, at 363.

152. *Id.* at 356.

153. *Id.*

154. Remember that under the studio contracts, the accounting periods were anywhere from three months to one year.

155. Participations in the Entertainment Industry, *supra* note 9, at 363.

ings from this clause over the Fox clause, the savings here could also be more than a half a million dollars. Thus, in interest charges alone, the SAG contract could result in \$1 million being subtracted from negative cost than under the studio contracts.

#### *H. Agreed Overbudget Deduction*

The SAG contract does not provide for an overbudget deduction. Due to this, \$1,925,000 is saved over the Fox contract and \$2,000,000 is saved over the Warner Brothers contract in this area. This makes sense in the case of net profit participants, such as Patrick Participant, because they have no control over whether a picture goes over budget. Such overbudget deduction terms make more sense if included in the director's contract, since such a person has much more influence over keeping a picture within its budget than do the more minor players, such as Patrick, who usually receive *net* profit agreements.

#### *I. Calculating Net Profits*

Table 8

Total distribution fees	\$14,487,500
Distribution expenses	15,813,000
Deferments	696,000
Negative cost	22,000,000
Interest on negative cost	1,000,000
<u>Gross participations</u>	<u>5,568,000</u>
Total deductions from gross receipts	\$59,564,500
Gross receipts	\$69,600,000
<u>Total deductions from gross receipts</u>	<u>(\$59,564,500)</u>
Net profits	<u>\$10,035,500</u>

If the net profits are reduced by more than 10% of the amount that would have been otherwise determined as net profits, the deduction for participations must be limited to this 10% figure.

Table 9

Gross receipts	\$69,600,000
<u>Deductions without participations</u>	<u>(53,996,500)</u>
Net profits without participations	\$15,603,500
	× 10%
	<u>\$ 1,560,350</u>

Since the gross participations reduce the net profits by more than \$1,560,350 (referring to 10% of the net profits without subtracting the

gross profit participations), the reductions for participations are limited to this amount under the terms of the SAG contract. Thus, net profits are \$15,603,500 minus \$1,550,350, or \$14,053,150.

### J. General Accounting Provisions

The SAG policy toward foreign receipts is similar to Fox's in its requirement that receipts be included in gross receipts as soon as they can be converted into United States dollars or when the studio uses the funds for its own account.<sup>156</sup> The contract also contains the provision, contained in both studio contracts, that the participant can request payment of restricted funds to a bank account or other designated representative in the country involved.<sup>157</sup> Thus, the SAG contract contains all of the foreign currency terms favorable to the participant which are contained in either major studio contract.

Regarding assignment by a participant, the SAG contract does not contain the right of first refusal provision included in Fox's contract. Rather it is virtually identical to Warner's provision, except it requires appointment of a disbursing agent if there is to be more than one assignee, rather than merely allowing one at the studio's option if there are more than three assignees.<sup>158</sup>

## VI. CONCLUSION

Larry King has stated, "I once fleetingly glimpsed that rare bird the whooping crane, but have yet to set eyes on a producer-into-profits. Any accountant careless enough to permit a producer to cross over into profits shall not in the future find much use for his pencil."<sup>159</sup> But, as David Leedy said in *The Financial Story Behind Phenominal Picture*, while "[p]articipation agreements are complex, and, in most cases due to the lack of commercial success, unnecessary. . . , in those few instances where a motion picture is a commercial success, proper understanding of the business and careful drafting of the participation agreement can be worth hundreds of thousands (if not millions) of dollars."<sup>160</sup>

The Patrick hypothetical showed how the various terms in the different participation contracts affect the outcome for the participant. Since Patrick receives 10% of net profits, under the SAG contract Pat-

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156. *Id.* at 361.

157. *Id.* at 361-62.

158. *Id.* at 366.

159. L. KING, NONE BUT A BLOCKHEAD 219 (1986).

160. D. LEEDY, MOTION PICTURE DISTRIBUTION: AN ACCOUNTANT'S PERSPECTIVE 65-66 (1980).

rick Participant makes 10% of \$14,053,150, or \$1,405,315. This deal still loses \$5,944,500 under the Fox contract, and \$11,278,250 under the Warner Brothers agreement. But under the SAG contract, Patrick would make almost one and a half million dollars. Relatively few changes in the wording of these contracts resulted in these huge differences.

This article has pointed out many terms of participation agreements, and explained what these terms really mean. A potential participant should use the article as a guide in attempting to negotiate some changes in his or her agreement with a studio. A potential participant should be aware of exactly what he or she is getting, which may well be nothing. If negotiations regarding the profit participation agreement are impossible, the participant may want to ask for more money up front. The key is — do not be drawn in by dreams of gold, but enter these agreements, if at all, with open eyes.

*Hillary Bibicoff\**

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\* The author wishes to dedicate this article to her father & mother, Harvey and Jacqueline, as well as her sister, Allison, for their love, support and encouragement. The author also thanks Professor Sobel for his assistance.



APPENDIX  
DEFINITION OF NET THEATRICAL PROFITS

*1. Definition of Parties:*

"Distributor" includes the Distributor, its affiliates and any subdistributor to whom Distributor grants theatrical and commercial television distribution rights and who is required to account to Distributor with respect to film rentals and related costs. As used herein, an "affiliate" of Distributor refers to an entity owned or controlled by Distributor, owning or controlling Distributor or under common ownership or control with Distributor.

"Participant" means the party with or which is entitled to participate in the net profits of the Picture, and successors and permitted assigns of such party.

*2. Net Profits:*

The net profits of the Picture means an amount equal to the excess, if any, of the gross receipts (as defined in 3 hereof) of the Picture over the aggregate of the following, which shall be deducted in the order listed:

(a) Distributor's distribution fees as set forth in 4 hereof.

(b) Distributor's expenses in connection with the distribution of the Picture, as set forth in 5 hereof.

(c) The cost of production of the Picture, as set forth in 9 hereof, plus an amount equal to interest thereon computed monthly from the respective date that each item thereof is paid until the close of the accounting period during which each such item is recouped, at a rate per annum equal to the prime commercial rate of the First National Bank of Boston from time to time in effect. For this purpose, an accounting period shall be deemed a calendar month. Interest shall be recouped before the cost of production.

(d) Payment to gross profit participants, as set forth in 10 hereof.

Net profits shall be determined as of the close of each accounting period as provided in 11 hereof.

*3. Gross Receipts:*

As used herein, the term "gross receipts" means the aggregate of:

(a) All film rental actually received by Distributor in respect of the Picture from parties exhibiting the Picture in theaters and on television.

(b) All amounts received by Distributor from outright sales or

licenses of theatrical distribution rights in and to the Picture for a flat sum.

(c) All amounts received by Distributor from the license, distribution or sale of trailers, souvenir programs and advertising accessories, remaining after first deducting all direct costs in connection therewith. Costs in excess of such amounts received shall be deductible as advertising expenses in 5 hereof.

(d) All amounts (other than those in (a), (b) and (c) above) received by Distributor from exploitation of rights to exhibit the Picture in schools, churches and other similar institutions or via pay television, cassettes, discovision, videotapes, ships at sea, airlines, industrial establishments and from exploitation of all other exhibition rights not specifically described herein, now known or arising in the future.

(e) All amounts received by Distributor from the exploitation of subsidiary rights (other than exhibition rights) in the Picture such as from the exercise of music rights (music publishing, phonograph records and soundtrack albums), merchandising and commercial tie-ups, publication rights including book publishing and novelization, home rentals, cassettes and from exploitation of all other subsidiary rights not specifically described herein, now known or arising in the future.

(f) All moneys actually received by Distributor on account of direct subsidies, aid or prizes relating specifically to the Picture and recoveries for infringement of copyrights.

It is recognized that Distributor, rather than an unrelated third party, may exploit directly some or all of the rights contemplated in (d) and (e) above, in which event Distributor may elect to include as gross receipts hereunder the amounts which would otherwise be payable to Distributor (rather than the amounts received by Distributor) had such exploitation been conducted by such unrelated third party. In the event of such election, Distributor shall (i) not deduct any costs in connection with such exploitation, and (ii) provide Participant with clear and convincing evidence that the amounts includable represent the highest amount Distributor could have received from an unrelated third party.

#### *4. Distribution Fees:*

Distributor shall deduct and retain for its own account the following amounts, determined by applying the percentages set forth below to the gross receipts described in the indicated subparagraphs of paragraph 3 above:

Subparagraph (a):

(i) 25% from all sources in the United States and Canada, ex-

cept that, with respect to receipts from a license for domestic network television exhibition, there shall be no fee;

(ii) 30% from all sources in the United Kingdom; and

(iii) 35% from all other sources.

Subparagraph (b): 10%.

Subparagraph (c): 10%.

Subparagraph (d): 10%.

Subparagraph (e): 10%.

Subparagraph (f): None.

The distribution fees provided for herein shall include, among other things, reimbursement to distributor for the cost of (i) all distributor employees rendering services, directly or indirectly, in connection with the distribution of the picture, including their salaries and out-of-pocket expenses, (ii) facilities, either owned or rented by distributor used in connection with distribution of the picture, (iii) sales and advertising conventions, including functions incident to the "Oscar" and other similar awards.

### 5. *Distribution Expenses:*

Deductible distribution expenses shall include the following costs which shall be determined after all related rebates and/or discounts granted Distributor, whether the discounts and/or rebates are based on total volume or otherwise determined.

(a) *Governmental Levies:* All costs of import fees and licenses, and other similar requirements to secure the right to import and distribute the Picture in any foreign country; import, export, tariff, customs and similar duties; all sums paid or payable by Distributor as taxes based upon the value of the Picture, or as import taxes, license fees and like charges, however denominated, imposed, assessed or levied by any Government, or any duly constituted taxing authority, whether such taxes are denominated as turnover taxes, sales taxes, film hire taxes, gross business taxes, remittance taxes or by any other denomination related to the Picture. Nothing herein contained, however, shall be deemed to mean that the net profit participant shall be obligated to pay or participate in net income, franchise excess profits or corporation taxes. Taxes imposed on foreign receipts which are eligible as foreign tax credits under the applicable provisions of the Internal Revenue Code shall not be deducted to the extent that such credits are used in full, except to the extent that the Distributor demonstrates otherwise.

(b) *Prints and Physical Properties:* Prints, replacement prints,

master discs and records; laboratory work; titles; dupe negatives and fine grain prints, redubbed tracks and foreign versions, including a version or versions synchronized with music or sound effects; substandard reductions; re-editing, recutting, rerecording and changes of or in the Picture; producing and adapting trailers, together with any of the foregoing costs in connection with trailers (other than costs deductible in 3(c) hereof); copyright protection, registration and renewal; and insurance premiums with respect to any of the foregoing items or with respect to any other physical properties relating to the Picture. If the methods or media of exhibition, transmission, projection or communication, or procedures, techniques or practices in connection with any of the foregoing, should be modified or changed, the corresponding costs of the new, substitute or changed methods, media, procedures, techniques or practices shall be deductible. The amounts deductible hereunder shall be net of any amounts received from the sale or license of positive prints or of any of the other physical properties described above and of any amount received from the scrapping or junking thereof.

(c) *Advertising:* Advertising, promoting, exploiting and publicizing the Picture in any way, including the following:

(i) publications, such as trade publications, fan magazines, newspapers, organization publications, and other space and display advertising, national and local;

(ii) cooperative advertising and advertising allowances to exhibitors (whether affected by credits against or deductions from film rentals, by direct reimbursement, or otherwise);

(iii) commercial tie-ups;

(iv) field exploitation;

(v) radio and television advertising, including cost of time and program and commercial preparation, recording and print and tapes;

(vi) tours and personal appearances of personalities connected with the Picture, including allowed living costs and traveling expenses of Distributor employees who are not executive or supervisory personnel and of other persons;

(vii) previews;

(viii) traveling and living expenses (but not salaries) of Distributor's publicity, advertising and exploitation employees, who are not executive or supervisory personnel, but only for trips directly attributable to the Picture;

(ix) entertainment, such as of press and personalities;

(x) art work, cuts and engraving; and

(xi) promotional materials, such as souvenirs, and the preparation, manufacture and dissemination of press books, and of any other advertising accessories (other than those direct costs deductible in 3(c) hereof) or materials, for free distribution.

(d) *Transportation and Censorship*: Freight, shipping, transportation, reels and containers, handling and other similar costs relating to prints and other physical properties of the Picture; censorship.

(e) *Checking*: Checking percentage engagements and licenses of the Picture.

(f) *Copyright cost, Claims and Litigation*: All sums expended or incurred in connection with the Picture in connection with any of the following: copyright and title reports, copyright registration and the like, changing titles in the Picture; music copyright and/or sound royalties; litigation, including court costs and reasonable attorneys' fees; claims or litigation in connection with any litigation or threatened litigation concerning title or rights in the Picture, or incidental to the assertion or maintenance of claims for the infringement of or with the Picture or any party thereof, or other interference by third persons of or with the Picture or any part thereof, or any rights granted to Distributor hereunder; and destruction of prints or other materials in connection with or relating to the Picture. Costs incident to proceedings in which participant is a principal litigant, adversary to distributor, are not chargeable hereunder.

(g) *Royalties and Residuals*: Synchronization, recording and performing royalties, and all other required payments, including residuals under collective bargaining agreements, for or with respect to the exhibition or exploitation of the Picture, theatrically or on television, against Participant's share of net profits. However, Participant's share of net profits shall not constitute an advance against Participant's residuals.

(h) *Trade Associations*: Dues, fees and contributions to the MPAA, AMPTP and MPEA or any similarly constituted organization, but only if and to the extent they are directly related to the picture.

(i) *Short Subjects*: The cost of providing a short subject to accompany the feature. However, if the short was not acquired solely and exclusively for such purpose, then the costs deductible hereunder shall be limited to costs of the type set forth in the other subparagraphs of this paragraph 5, relating to the distribution of the short subject. Solely for this purpose, any amounts paid by Distributor to unrelated participants in the income from the short subject, on account of the distribution of the short subject with the Picture, shall be deductible hereunder.

(j) *Subdistributor Expenses*: All items deducted by a subdistributor, as such is defined in 1 hereof, in its accountings to Distributor which

items would be otherwise deductible under the other pertinent subparagraphs of this paragraph 5 had they been incurred directly by the Distributor.

(k) *Reissue Expenses:* Distribution expenses incurred in connection with a reissue of the picture shall not be deductible hereunder to the extent such expenses exceed the gross receipts from reissue less applicable distribution fees thereon.

#### 6. *Film Rentals:*

Film rentals shall be determined after all refunds, credits, discounts and allowances and adjustments granted to exhibitor and, if Distributor elects the accrual method of accounting in 11(b) hereof, after any bad debts.

Distributor may, at its option, elect to include payments, such as advances, guarantees, security deposits and the like, either when earned or when received. Should Distributor elect to include such payments when earned, Distributor shall include as gross receipts (without distribution fees) interest on such payments (net of applicable distribution fees) at the rate set forth in 2(c) hereof, computed from the date the payment was received to the date earned or, if not earned, then to the date such payment was returned or credited to the payor thereof.

Where allowances are granted and paid on account of cooperative theater or joint advertising, such payments shall not be deducted in determining film rental and, where deducted by the exhibitor, shall be added back to the film rental received from such exhibitor, and all such allowances and payments shall be treated as advertising expenses deductible under 5(c) hereof. Wherever Distributor exhibits the Picture in a theater or over a television station owned or controlled by Distributor, or licenses the Picture or rights connected therewith to theaters, television stations or other agencies in which Distributor has an interest directly or indirectly, or to which Distributor is obligated to pay a fixed sum for exhibiting the Picture or for the use of its premises or facilities, Distributor shall include in the film rental of the Picture such sums as would have been determined had Distributor dealt at arms length with such theater, television station or other agency.

#### 7. *Foreign Receipts and Expenses:*

(a) No foreign receipts are includable in gross receipts until converted into U.S. dollars, or could be so converted if Distributor desired to do so. Distribution expenses paid in foreign currencies are not deductible until the gross receipts to which they relate are converted (or are convert-

ible) into U.S. dollars. Conversion shall be made at the same exchange rates as those used in converting the related gross receipts. Such expenses (e.g. prerelease distribution costs) which are unrelated to gross receipts shall be deductible when paid or accrued at conversion rates then in effect.

(b) Foreign currency which cannot be converted into U.S. currency is "restricted currency." If Participant otherwise would be entitled to payment except that foreign receipts of the Picture are in restricted currencies, Distributor agrees to so notify Participant, and to advise Participant of the amount of such receipts which would be payable to Participant, if not restricted. Participant shall then have the right to notify Distributor to make settlement of Participant's share of such receipts in the currency of the country or countries where such restrictions exist, by payment to a bank or other representative designated by Participant to whom payment may be made under applicable law. Upon receipt of such a notice from Participant, Distributor will make settlement in the manner specified in Participant's notice. Should Distributor use restricted receipts for Distributor's own account, Distributor shall include the amount of restricted receipts so used in gross receipts computed at the official rate of exchange prevailing on the date of use of said receipts by Distributor. Distribution expenses incurred in restricted currencies are not deductible until settlement is made in the manner set forth herein, converted at the same rate of exchange as that used to convert the related gross receipts.

(c) Should Distributor, pursuant to 11(b) hereof, elect the accrual basis of accounting then, notwithstanding (a) above, foreign receipts which are not restricted funds, shall be includable when billed or earned at the rates of exchange then prevailing.

#### 8. *Allocation:*

(a) Should Distributor make an expenditure, which constitutes a distribution expense herein with respect to a group of motion pictures (including the Picture), the amount thereof allocable to the Picture shall be measured with reference to the same factor or activity by which such expenditure was (directly or indirectly) measured. Thus, by way of example, if the expenditure was measured by the gross receipts of the group of pictures (including the Picture) or by the number or prints of such group shipped, the allocation shall be similarly measured. Should the amount of the expenditure be unrelated to the Picture, then, notwithstanding the provisions of 5 hereof, the expenditure is not deductible.

(b) Should Distributor receive from a licensee either a flat sum or

percentage of the receipts, or both, for rights to exploit via theatrical or television exhibition or otherwise, a group of motion pictures (including the Picture) within a territory, the amount thereof allocable as gross receipts with respect to the Picture shall be determined on the basis of the relative theatrical gross receipts of each picture in the group from all prior sources within the territory (other than from such license). In the event that any picture in the group has not been in distribution for at least two years at the time of such license, the amount allocable shall be reasonably determined on a tentative basis and adjusted subsequently so as to take into account the initial two years of gross receipts of such picture or pictures. Other factors, in addition to gross receipts, may be taken into account in making the allocation provided for in this subparagraph (b) only if Distributor and/or Participant is able to demonstrate that such other factors had a material influence on the amount of such license.

(c) Where the Picture is exhibited with a short subject, no part of the gross receipts shall be attributed to such short, except the flat sum, if any, provided for in the exhibition agreement.

#### 9. *Cost of Production:*

The "cost of production" of the Picture means the total of all direct costs paid or incurred by Distributor in connection with the production of the Picture plus such actual overhead costs incurred by distributor as are reasonably related to the production of the Picture. In no event, however, shall such overhead costs exceed 10% of the total of all such direct costs. In determining such direct costs, deferments, representing a fixed cost of production contingently payable in the future out of the profits of the Picture, shall be taken into account. Direct costs shall be reduced by the amount of any investment credits allowable to Distributor under the applicable provisions of the Internal Revenue Code and it shall be presumed that such credits are used in full except to the extent Distributor demonstrates otherwise. No cost deductible as a distribution expense hereunder shall be included as a direct cost of production. The full amount of direct costs for which Distributor is contractually obligated shall be included at the time the liability therefor is incurred but interest, however, shall be calculated from the date of payment. No later than 15 days after delivery to Participant of the first earnings statement hereunder, Distributor will (subject to subsequent revision) deliver to Participant an itemized summary of the cost of production.



### 10. *Gross Profit Participation:*

Gross profit participants are those who are to receive contingent payments based on a percentage of gross receipts (which may be reducible by certain distribution costs limited in type and/or amount), whether the participation be from the first dollar of gross receipts or from a stated amount(s) of gross receipts. For this purpose payments measured by a percentage of gross receipts remaining after a rolling or moving breakeven do not constitute payments to gross profit participants. No payment to a gross profit participant shall constitute a cost of production. The total amount deductible by reason of payment to gross profit participants shall be limited so that the net profits herein shall not be reduced by more than ten percent (10%) of the amount that would have been otherwise determined as net profits herein were there no gross profit participants.

### 11. *Earnings Statement:*

(a) Distributor shall render to Participant, at the address set forth in the foregoing statement, periodic statements showing, in summary form, the appropriate calculations under this agreement. Statements shall be issued for each calendar quarter until the Picture has been in release for 4 years from and including the quarter in which the Picture was first released, semi-annually for the next 2 years and annually thereafter; provided however, that quarterly statements shall be resumed during any general theatrical reissue of the Picture, and a quarterly statement shall be rendered for the quarters during which amounts are includable as gross receipts on account of U.S. network television exhibition. Statements shall be rendered within 60 days after the close of the accounting period. Each such quarterly, semi-annual or annual period, as the case may be, is herein referred to as an "accounting period." No statements need be rendered for any accounting period during which no receipts are received or charges incurred. Statements rendered by Distributor may be changed from time to time to give effect to year-end adjustments made by Distributor's accounting department or public accountants, or to items overlooked, to correct errors and for similar purposes. Any amounts due and payable to Participant by Distributor pursuant to any such statement shall be paid to Participant simultaneously with the rendering of such statement provided, however, that all amounts payable to Participant hereunder shall be subject to all laws and regulations now or hereafter in existence requiring the deduction or withholding of payment for income or other taxes payable by or assessable against Participant.

(b) Earnings statements may, at the election of Distributor, be rendered on a cash or accrual basis of accounting. The election shall be made by Distributor in the first such statement issued and the method of accounting so elected may not thereafter be changed. For this purpose, "accrual basis" includes the reporting of film rentals when billed; and "cash basis," the reporting of expenses when vouchered, if, under Distributor's accounting system, such expenses are payable shortly thereafter.

(c) Should Distributor, because of computational mistakes, accounting errors or otherwise, understate in any statement the amount payable to Participant, Distributor shall pay interest, at the rate set forth in 2(c) herein, on the amount of such understatement from the date such amount was payable to the date paid. Similarly, interest shall be charged on any overpayment made by Distributor. However, no interest shall be paid or charged, as the case may be, on any underpayment or overpayment of less than \$25,000.

(d) For purposes of (a) above, foreign (other than Canada) film rentals and related costs shall be deemed timely reported, if included within the accounting period 30 days later than they would have been included had such rentals and costs related to the domestic, rather than the foreign, territory.

(e) Should Distributor elect the accrual basis of accounting pursuant to (b) above, then any gain or loss resulting from the subsequent conversion of foreign currencies into U.S. dollars shall be taken into account in determining foreign gross receipts includable and foreign distribution costs deductible herein. Since the amounts of such gain or loss with respect to the Picture may not be separately identifiable as to such receipts and costs, an appropriate allocation shall be made to determine the respective amounts attributable to receipts on the one hand and costs on the other. Such amounts shall represent an increase or decrease, as the case may be, of gross receipts otherwise includable or distribution expenses otherwise deductible.

## *12. Accounting Records; Audit Rights:*

Distributor shall keep books of accounts relating to the production and distribution of the Picture, together with vouchers, exhibition contracts, license agreements and similar records supporting the same (all of which are hereafter referred to as "records"). Participant may, at its own expense, audit the applicable records at the place where Distributor maintains the same in order to verify earnings statements rendered hereunder. Any such audit shall be conducted only by a reputable certified

public accountant during reasonable business hours and in such a manner as not to interfere with Distributor's normal business activities. In no event shall an audit with respect to any earnings statements commence later than 36 months from the date of the dispatch to Participant of the earnings statement involved. Distributor shall provide said auditor with a chair and desk at which to work and shall allow the auditor to make copies of records. Participant's right to examine Distributor's records is limited to records of the Picture, plus such other records as are necessary to audit an item of income or cost with respect to the Picture which is determinable with reference to some other item of income realized or cost incurred by the Distributor.

### *13. Sale by Distributor:*

If Distributor sells all of its rights, title and interest in the Picture, Participant, upon notice from Distributor of such sale, shall elect to (a) have the proceeds of the sale received by Distributor included in Gross Receipts (without any distribution fee thereon); or (b) deem such sale a novation. If Participant proceeds under the election in (b), Distributor will deliver to Participant in writing an assumption agreement signed by the party buying the Picture, in which the Buyer agrees to perform all of Distributor's obligations hereunder, and Participant agrees to release and discharge Distributor from any further liability with respect to the payment of monies which may thereafter become payable hereunder, and to look solely to such buyer for any such future payment. Participant agrees to make the election within ten (10) business days of receipt of Distributor's notice of sale which notice shall include a copy of the sale agreement and, if Participant fails to do so, Participant shall be deemed to have elected (b) above. In any proceeding involving an earnings statement, the distributor shall bear the burden of proving the correctness thereof.

### *14. Assignment by Participant:*

At any time after the first general release of the Picture, Participant shall have the right to assign, in whole or in part, its right to receive participation payments hereunder, provided that (i) any such assignment is irrevocable, (ii) each assignee executes a notice to Distributor that it understands that any such assignment is on all the terms and conditions herein contained, and (iii) if there is to be more than one assignee, a disbursing agent is to be appointed to whom Distributor shall make all payments, regardless of any future assignment. Distributor's payment in accordance with any such assignment shall release and discharge Distrib-

utor from any further liability or obligation with respect thereto. As long as Participant shall have made a partial assignment hereunder, Participant shall retain the right to inspect and audit Distributor's books and records. If such assignment is an outright assignment made to a single assignee, said assignee shall have the right of inspection and audit as to events occurring after the date of such assignment, and if more than one assignee is involved, the disbursing agent shall have these rights.

